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THE DILEMMA OF THE LOCAL SOCIAL INVESTMENT: AN ESSAY ON 'SOCIALLY RESPONSIBLE' INVESTING

*Edward A. Zelinsky**

INTRODUCTION

Like any political movement that seeks to change the status quo in a dramatic way, the drive for the "socially responsible" investment of pension and endowment funds has generated many questions about the nature, scope, and propriety of its aims. Among the varied issues that have emerged from the debate over social investing, perhaps none has been more sharply argued than the propriety of such investing as evaluated under the traditional criteria of fiduciary law.

Historically, fiduciaries have been required to diversify the assets under their control and to seek the highest rate of return consistent with the preservation of those assets.¹ Some opponents of social investing contend that the often suggested criteria for social investments will inhibit the diversification of fiduciaries' portfolios and will lead to lower rates of return than would otherwise be obtainable.² If, for example, a pension plan cannot invest in nonunion companies, the universe of available investments will be constricted. Under this analysis, the pension trustee proscribed from making profitable nonunion investments will develop a less diverse and less profitable portfolio than the trustee not so proscribed.

To the proponents of social investing, there is no insuperable incompatibility between the investment criteria they propose and the fiduciary's traditional obligations to diversify and make productive the funds under his control.³ Diversification, under this view, can be achieved with relatively few investments. From this perspective, there is no reason to believe that companies with factories in South Africa

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¹ See *infra* notes 19-25 and accompanying text.

² See *infra* notes 13-17.

³ *Id.*

will necessarily have higher rates of return than firms with no establishments in that country.

As a modest contribution to this debate, I suggest that the relationship among social investing, diversification, and rates of return can best be evaluated if we distinguish between two types of social investments: the "local" social investment and the "global" social investment. The former is an investment that, in addition to its direct rate of return, generates secondary economic benefits for the fiduciary's beneficiaries. In many instances, the local social investment will, because of these extra benefits, yield a higher rate of return than more traditional investments. On the other hand, the local social investment—precisely because of its local nature—will be among the least diversifying of the investments available to the fiduciary. The paradox of the local social investment—its high rate of return but undiversified nature—forms the core of my analysis.

Central to my position is the concept, widely accepted among economists but as yet unfamiliar to fiduciary law, of the externality, i.e., the secondary financial benefit generated by an economic activity. It is not surprising that the jurisprudence of fiduciary obligation has not addressed the question of externalities since that body of law traces its origins to a preurbanized, preindustrial world where externalities were less common than they are today.⁴

I suggest that the fiduciary's obligation to maximize his rate of return is appropriately characterized as an obligation to maximize a rate of return that includes the beneficiary's portion of any externalities. So defined, the fiduciary's obligations would not simply permit, but often would compel, the local social investment on the basis of rate of return. Phrased differently, the rate of return on the local social investment, calculated to account for its externalities to the beneficiary, will often be higher than the return on traditional, nonsocial investments.

Life, however, is never simple. While local social investments will often be the most productive investments available to a fiduciary, generally they will also be the least diversifying. Typically, the fiduciary will already have a major investment in the locality to be benefited by the proposed local social investment. Thus, ironically, one traditional criterion of fiduciary law (rate of return) will frequently impel the fiduciary to make local social investments while another criterion (diversification) will generally forbid it. This is the dilemma of the local social investment.

⁴ See *infra* note 78 and accompanying text.

To resolve this dilemma, I propose that a specific category of investments be recognized as a matter of fiduciary law. This category would be denoted "reciprocal local social investments" and would reflect the fiduciary's power (and perhaps compulsion) to make the local social investment of another fiduciary in return for that second fiduciary's agreement to make a reciprocal investment of the assets under his control.

I will develop my analysis in seven steps. First, I will create four examples that will be used throughout this Article. Second, I will examine the background of social investing and will amplify the distinction between the local social investment and the global social investment. Third, I will briefly explore the legal framework presently controlling the investment obligations of fiduciaries. Fourth, I will analyze the economist's concept of the externality. Fifth, I will examine how the local social investment, because of its externalities, will often be the most productive, if least diversifying, investment available to the fiduciary. Sixth, I will introduce the concept of the reciprocal local social investment as an addition to the body of fiduciary law and will outline the manner in which a nationwide clearinghouse could facilitate the reciprocation of local social investments. Finally, I will examine some potential objections to my analysis.

I. FOUR EXAMPLES

To advance my various themes, I will utilize four examples. The first involves a university located in an urban setting in the city of Westville, a middle-sized community in New England. The university is well endowed. The most recent valuation of the university's investment portfolio concluded that the university's income producing assets are worth \$300 million. The campus itself is a major holding of the university, valued by the local assessor at \$100 million. Parts of the university's campus abut the downtown area of Westville. In recent years, the downtown area has stagnated. Of the university's investment portfolio, \$50 million represents commercial real estate in downtown Westville.

To revitalize downtown, the city of Westville recruits an experienced out-of-state developer to acquire, refurbish, and upgrade several blocks of downtown real estate. The developer needs financing. More particularly, the developer needs a mortgage below market rates for his proposal to work. The developer and the city approach the university for a loan for the developer. That loan would be made from the university's endowment fund and would be in the amount of \$10 million, for ten years, at an 8% rate of return. The proceeds

would be invested exclusively in the developer's downtown project. The university's endowment advisors indicate that, if the university rejects the loan request, it could obtain 10% return by investing the funds elsewhere.

There is no local source available for the proposed mortgage other than the university's endowment. If the university does not agree to the city's proposal, there will apparently be no downtown project.⁵

At the same time that the university has before it the proposal from the city and the developer, the university is being pressured by certain segments of its student body to divest the stocks of specified corporations that depend heavily on military contracts. These stocks currently generate a return of 10%. The university's advisors believe that, if these stocks are sold, the proceeds could not be reinvested at that rate of return and would therefore generate a lesser income to the university.

My second example pertains to the profit-sharing plan of a corporation that is in the home construction business in the industrial midwest. Under the terms of the plan, one-third of the corporation's pretax profits are automatically contributed to the plan. The plan satisfies the legal requirements of the Internal Revenue Code ("Code") for profit-sharing arrangements.⁶ The participants in the plan are the employees of the corporation who have attained twenty-five years of age. The corporation's nonmanagement employees are paid on an hourly basis. The president and the treasurer of the corporation serve as trustees for the assets contributed to the plan.

In Elmtown, the community where the corporation does the bulk of its business, the homebuilding market has stagnated because of high mortgage rates and the lack of available mortgage money. Consequently, for the past three years, the corporation has had no profits and thus has made no contribution to the profit-sharing plan. Indeed, most nonmanagement employees of the corporation have been working substantially less than forty hours per week.

The corporation is approached by its employees with the following proposal: The trustees will sell certain long-term corporate bonds held by the profit-sharing plan. The plan earns a rate of return of

⁵ For those who suspect that this example is something of a *roman à clef*, see Yale Chips in For New Haven, N.Y. Times, Feb. 13, 1983, § 4, at E7, col. 3; Yale Ponders Shubert Investment, New Haven Reg., Nov. 20, 1982, at 30, col. 3. In the interests of full disclosure, I should note that I serve as a member of the Board of Aldermen of New Haven and voted for the city's participation in both of the projects described in these articles.

⁶ I.R.C. § 401. All statutory references, unless otherwise indicated, are to the Internal Revenue Code of 1954, as amended.

13% on these bonds. These bonds total \$2 million and represent one-tenth of the plan's current assets. The proceeds from the sale of the bonds will be conveyed to a local savings bank that will, on behalf of the plan, loan the proceeds for new home construction mortgages in Elmtown. For the first three years, each mortgage will bear an interest rate of 11%, 2% less than the return the plan could otherwise obtain. In the fourth year, and for each year thereafter, each mortgage's interest rate will automatically adjust to market levels. Hence, the prospective mortgagor will receive a subsidy during the first three years he owns his house.

While the trustees contemplate this proposal, they are asked by a local environmental group to divest their portfolio of all securities issued by companies that produce certain artificial pesticides, and to invest the proceeds in the newly issued stock of a corporation that produces experimental equipment for industrial solar heating components designed for Florida and other southern states. The securities proposed for divestiture bear an average rate of return of 15%. The stock of the solar equipment company is highly speculative, as the company has yet to pay any dividends.

My third example involves the pension plan maintained by a national, nonprofit church organization for its full-time salaried employees. The organization provides a variety of administrative and educational services to local, affiliated churches. Affiliation is purely voluntary and may be terminated by the church at any time. The organization's pension plan satisfies the requirements of the Internal Revenue Code⁷ and is of the defined benefit variety,⁸ i.e., upon attaining age 65, each employee is guaranteed a specific annual pension regardless of the plan's investment performance during the employee's working career. In particular, each employee is assured, upon his retirement, an annual pension equal to 60% of his average yearly salary as of the end of his employment.

Each year, the plan's professional actuary determines the level of funding that the organization must contribute to the plan. The organization's funds come from two major sources. First, each affiliated church makes a mandatory payment based on the size of the church's congregation. In addition, the organization's staff conducts direct-

⁷ Id.

⁸ In a defined benefit pension plan, the employer pays a specified benefit at the employee's retirement. Such benefit is calculated from a formula that is part of the plan. The employer's contribution is based on an actuarial valuation of how much money will be needed to fund the promised benefit upon the employee's retirement. Hager & Zimpleman, *The Norris Decision, Its Implications and Application*, 32 Drake L. Rev. 913, 934 (1983).

mail fundraising appeals principally aimed at the congregants of the affiliated churches.

Throughout its history, the organization has been involved in a number of political and religious controversies. Frequently, affiliated churches have responded to these controversies by terminating or suspending their memberships in the organization. The organization's income is directly and adversely affected when a church departs in this fashion.

To protect the plan's participants, the church organization has elected to participate in the federally sponsored insurance program of the Pension Benefit Guaranty Corporation (PBGC).⁹ In return for an annual premium, the PBGC insures a basic retirement benefit for each participant in the plan.

The following proposal has been advanced to the plan's trustees: \$10 million of the pension assets under their control will be loaned to churches that are located in impoverished rural and urban areas throughout the nation, and that are in the process of erecting new buildings or expanding or improving old ones. The trustees, as security for the loans, will receive mortgages from the borrowing churches. The churches will each borrow at an 8% rate of return for a ten-year term. This is 2% less than the return the trustees could otherwise obtain. Each borrowing church will enter into a contract with the organization, committing the church to affiliate with the organization until its loan is paid off in full.

Simultaneously, the trustees have been urged by a caucus of churches to sell all pension holdings of companies that have factories or branch offices in South Africa, that sell to companies with such factories or offices, or that sell to the government of South Africa. The resulting funds would be invested in other, listed companies. The holdings affected under this proposal currently generate an aggregate return of 10%. The companies in question constitute a large percentage of the firms listed on the New York and American stock exchanges. Outside investment counsel has indicated that, if the plan invests in the remaining firms on the two exchanges, it can expect a rate of return lower than 10%.

A fourth and final example pertains to the public employees' pension plan of a small New England state. The managers of the plan

⁹ For an introduction to the federal insurance of pension plans, see the legislative reports accompanying The Employment Retirement Income Security Act of 1974, H.R. Rep. No. 533, 93d Cong., 2d Sess. 935, reprinted in 1974 U.S. Code Cong. & Ad. News 4639, 4652-54, 4662-64, 5142-61, & 5171.

have been approached by local real estate interests to commit \$5 million for thirty-year, fixed-rate, low-interest mortgages.

Under the proposal, funds from the state pension plan would be used for mortgages to first-time home buyers who purchase or build anywhere in the state. These mortgages would bear a permanent rate of 10%. That rate is 2% less than the plan could otherwise obtain and 3% less than the current rate for thirty-year, fixed-rate, low-interest mortgages.

The state does not levy an income tax. It does, however, levy a 7% sales tax, which applies to the materials purchased for new home construction. The state also imposes a 7% real estate conveyance tax levied on the gross sales price of all real property sold within the boundaries of the state. The state's financial position, while not without its problems, is essentially acceptable.

The plan is of the defined contribution type.¹⁰ Each year, the state contributes for each employee participating in the plan an amount equal to 5% of the employee's salary in that year. Upon retirement, the employee is entitled to the state's cumulative contributions on his behalf plus the cumulative earnings attributable to those contributions.

II. LOCAL SOCIAL INVESTMENTS AND GLOBAL SOCIAL INVESTMENTS

The proposals to our hypothetical university, corporation, church organization, and state pension plan typify what has come to be called the social investment. The concept of the social investment is one that has emerged relatively recently with the recognition that the assets of institutions, such as pension and profit-sharing plans, foundations, and university endowments, are of significant magnitude.¹¹ Among the reasons for this growth is the favorable tax treatment afforded to contributions to these institutions and to the institutions' earnings.¹²

If the growth of pension, university, and foundation assets was the factual predicate to the demand for social investing, the case for

¹⁰ In a defined contribution plan, the amount of contribution to be made by the employer, rather than the level of benefits to be provided to the employee upon retirement, is specified in the plan. Hager & Zimpleman, *supra* note 8, at 935-36.

¹¹ On the size of these funds, see *Assets Surge to \$806 Billion, Pensions and Investment Age*, Jan. 23, 1984, at 3; *College Endowments Grow by Millions With Surge in Market*, N.Y. Times, July 23, 1983, at A5, col. 2.

¹² I.R.C. §§ 170, 401(a), 404(a), 501(a). Section 170(a) allows a tax deduction for charitable contributions. A charitable contribution is defined generally in § 170(c) as a contribution or gift to:

social investing still requires acceptance of a key normative premise: fiduciaries, in making investment decisions, may (or must) consider the political, economic, and social effects of those investments.

Over the last decade or so, there has developed increasing interest in deploying pension and endowment assets to further social goals.¹³ Universities have been pressured to divest their portfolios of the stock of corporations doing business in South Africa.¹⁴ State and

1) A state, the United States, a possession of the United States, a political subdivision thereof, or the District of Columbia provided that the contribution is made for exclusively public purposes.

2) A corporation, trust, or community chest, fund, or foundation—

A) created or organized in the United States, any state, the District of Columbia, or any possession of the United States; and

B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, national or international amateur sport competition, or for the prevention of cruelty to children or animals.

3) other organizations listed in § 170(c)(3), (4), (5).

Section 401(a) lists the requirements for qualification as a pension, profit-sharing, or stock bonus plan.

Section 404(a) allows a tax deduction for contributions paid by an employer to an employee's stock bonus, pension, profit-sharing, annuity, or deferred-payment plan.

Section 501(a) exempts certain organizations, specifically those described in §§ 401(a), 501(c), and 501(d) from taxation. Section 501(c) includes, among other things, a corporation, community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, public safety, literary, or educational purposes, or to foster a national or international amateur sports organization, or for the prevention of cruelty to animals and children.

The hypothetical university, corporation, state, and church described in this Article, see *supra* text accompanying notes 5–10, would all be afforded favorable tax treatment under the Code.

¹³ Hutchinson & Cole, *Legal Standards for Governing Investment of Pension Assets for Social and Political Goals*, 128 U. Pa. L. Rev. 1340, 1342–43 (1980); Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 Lab. L.J. 387, 387 (1980); Lynn, *Investing Pension Funds for Social Goals Requires Changing the Law*, 53 U. Colo. L. Rev. 101, 101 (1981); Schotland, *Should Pension Funds Be Used to Achieve 'Social' Goals?* (pt. 1), Tr. & Est., Sept. 1980, at 10, 11 (later articles in this three part series are found in Tr. & Est., Oct. 1980, and Tr. & Est., Nov. 1980); *Investment Challenge*, Pensions & Investment Age, Sept. 17, 1984, at 59, col. 5 (letter of John C. Harrington); *Stand on S. Africa Needs Challenge*, Pensions & Investment Age, Aug. 20, 1984, at 8, col. 1; Schlesinger, *Investing Based on Social Issues is Gaining Adherents Among the Children of the '60s*, Wall St. J., July 11, 1984, § 2, at 33, col. 4; *Anti-Apartheid Pension Policies Criticized by Some Fund Managers*, Wall St. J., Apr. 18, 1984, § 2, at 33, col. 4; Shapiro, *Doing Well While Doing Good*, N.Y. Times, Aug. 7, 1983, § 3, at 17, col. 1; *Funds with a Conscience*, N.Y. Times, Mar. 20, 1983, § 3, at 1, col. 1; Brody, *Pure-Play Investments: Socially Sensitive Portfolios Are Gaining in Popularity*, Barron's, Jan. 24, 1983, at 13, col. 1; *'Power' Is the Real Social Issue*, Pensions & Investment Age, Dec. 6, 1982, at 10, col. 1 (editorial); *'Socially Responsible' Funds Pique Interest, But Results Often Have Been Unimpressive*, Wall St. J., Nov. 18, 1982, § 2, at 33, col. 4; *Financial Institutions Show Interest In Socially Responsive Investing*, 14 Sec. Reg. & L. Rep. (BNA) No. 40, at 1752, 1752–53 (Oct. 15, 1982).

¹⁴ See Note, *Socially Responsible Investment of Public Pensions Funds: The South Africa Issue and State Law*, 10 N.Y.U. Rev. L. & Soc. Change 407, 412 (1980–81); *Harvard Won't Bolster Anti-Apartheid Policies*, Wall St. J., Oct. 2, 1984, § 2, at 46, col. 2; *Campbell, More Municipalities Joining Drive to Cut South Africa Links*, N.Y. Times, Sept. 25, 1984, at A1,

local government pension funds have been used to provide mortgages for homeowners within the governments' respective boundaries and to encourage economic development.¹⁵ Foundations have been asked to refrain from investing in corporations that work on Pentagon contracts.¹⁶ Unions have demanded that pension funds be invested only in unionized corporations.¹⁷ The list could go on.

col. 6; N.Y.C. Trustees Approve Resolution on South Africa, *Pensions & Investment Age*, Aug. 20, 1984, at 40, col. 1; Phased-In Divestiture Urged, *Pensions & Investment Age*, July 23, 1984, at 34, col. 1; Dunlap, Some Trustees Want City Pension Funds to Cut Pretoria Ties, *N.Y. Times*, Mar. 7, 1984, at A1, col. 6; Labor Letter: South Africa's Racial Policies Force Pension Funds to Shed Some Stock Holdings, *Wall St. J.*, Feb. 14, 1984, at 1, col. 5; Wesleyan to Sell S. African Stock, *New Haven Reg.*, Feb. 5, 1984, at 10, col. 1; South Africa Ties Broken by Yalies, *New Haven Reg.*, Dec. 14, 1983, at 1, col. 1; Apartheid Foes Push Yale Divestment, *New Haven Reg.*, Dec. 11, 1983, at 1, col. 1; Divesting Report Released, *New Haven Journal-Courier*, Dec. 6, 1983, at 16, col. 2; Apartheid Resolution Rejected at Columbia, *N.Y. Times*, July 3, 1983, § 1, at 17, col. 4; Penn, Investing in South Africa: Moral Issue With a Bottom Line, *N.Y. Times*, May 15, 1983, § 3, at 2, col. 3; University to Protest New Divestiture Law, *Pensions & Investment Age*, May 2, 1983, at 19, col. 1; Bond, U.S. Foes of Apartheid Curb South Africa Investment, *New Haven Journal-Courier*, Apr. 18, 1983, at 10, col. 3 (editorial); Michigan Regents Bob and Weave, *N.Y. Times*, Apr. 17, 1983, § 4, at 7, col. 2; Ann Arbor Argues State Stock Rule, *N.Y. Times*, Apr. 13, 1983, at A7, col. 1; The States and Apartheid, *Wall St. J.*, Feb. 22, 1983, § 2, at 33, col. 1; Shunning South Africa, *Bus. Wk.*, Jan. 17, 1983, at 44, col. 4; UAW-Chrysler Pension Fund Trustees Asked Not to Invest in Nine Companies, 10 *Pens. Rep. (BNA)* No. 470, at 1729 (Nov. 14, 1983).

¹⁵ See Murphy, *Regulating Public Employee Retirement Systems for Portfolio Efficiency*, 67 *Minn. L. Rev.* 211, 216, 223-24 (1982); California Auditor: Small Public Funds Not in Step with Law, *Pensions & Investment Age*, Sept. 17, 1984, at 27, col. 4; State's 4-Way Venture Capital Plan Aims for Double Benefit, *N.Y. Post*, Feb. 9, 1984, at 46, col. 2; New York State Retirement Fund Plans Venture-Capital Investment, *N.Y. Times*, Dec. 26, 1983, at B2, col. 1; State to Switch Funds to Industry, *N.Y. Post*, Dec. 26, 1983, at 33, col. 6; Prial, New Pension Fund Role: Saving Housing, *N.Y. Times*, Aug. 7, 1983, § 8, at 7, col. 2; Ruhe & Westerbeck, Pension Plans Cornerstone in Pittsburgh Development, *Pensions & Investment Age*, May 2, 1983, at 1, col. 3; Sahgal, Pensions Could Add Zest to State's Capital Pool, *Pensions & Investment Age*, May 2, 1983, at 21, col. 1; Gov. Cuomo: 'I Intend to do More with Less', *N.Y. Post*, Jan. 10, 1983, at 32, col. 5 (letter of Mario M. Cuomo, Governor of New York); Gallagher, Use \$16B Pension Fund to Build State Economy, *N.Y. Post*, Oct. 25, 1982, at 29, col. 1 (editorial); At Least \$60 Million Set as Yankee Mac Offering, *New Haven Journal-Courier*, May 18, 1982, at 1, col. 1; State Makes \$300 Million Available for Mortgages, *N.Y. Times*, May 6, 1982, at D17, col. 3; Investment Unit Report Discusses Use of Plan Assets to Stimulate Economy, 10 *Pens. Rep. (BNA)* No. 429, at 183, 183 (Jan. 31, 1983); Cuomo to Continue Drive to Use Pension Funds to Aid State Economy, 9 *Pens. Rep. (BNA)* No. 418, at 1576, 1576 (Nov. 8, 1982); Legislature in Midst of Revamping Investment Practices of Largest Funds, 9 *Pens. Rep. (BNA)* No. 416, at 1485, 1486 (Oct. 25, 1982).

¹⁶ See Glynn, *Pulpit Politics*, *New Republic*, Mar. 14, 1983, at 11, 13; Church Questions Singer's Military Rule, *New Haven Reg.*, May 11, 1983, at 1, col. 1.

¹⁷ See Kaiser, *Labor's New Weapon: Pension Fund Leverage—Can Labor Legally Beat its Plowshares into Swords?*, 34 *Rutgers L. Rev.* 409, 412 (1982); Note, *The Employee Retirement Income Security Act of 1974 and Union Influence in Pension Fund Investment Decisions*, 12 *Fordham Urb. L.J.* 151, 157-59 (1984); Unions Discovering the Pension-Fund Vote, *N.Y. Times*, June 12, 1983, § 3, at 4, col. 3; Carpenters Invest in a Subdivision, *N.Y. Times*, Apr. 24, 1983, § 8, at 1, col. 5; California Unions Pour Money into Mortgages, *Pensions & Investment Age*, Nov. 22, 1982, at 14, col. 1; Plumbers Union Local Announces Program for

These demands insist that the investment decisions of fiduciaries neither be limited to traditional economic criteria (e.g., What is the rate of return? Will the investment appreciate in the future?), nor be concerned only with the welfare of the designated beneficiary of the assets in question (e.g., the government employee, the university budget, the union's retiree). Instead, these demands require the fiduciary to consider the impact of his investment decisions on society. The investment is to be social in the sense that the private interest of the fiduciary's beneficiary is not alone to control. The impact of the investment on others is to be considered as well.

The concept of social investing would introduce into the fiduciary relationship new parties and considerations. Traditionally, the fiduciary relationship has been viewed as a two-party affair involving one person (i.e., the trustee, the executor, the administrator) who holds and manages property for the benefit of a second (i.e., the trust beneficiary, the legatee, the heir). Consequently, the focus of conventional fiduciary jurisprudence is the regulation of this bilateral relationship.¹⁸

The advocates of social investing would redefine the fiduciary relationship as a three-party affair involving the fiduciary, the beneficiary, and society as a whole.

It is here that I advance the distinction between a local social investment and a global social investment. For among the third party "others," whose welfare may be affected by the fiduciary's decisions, are the fiduciary's beneficiaries themselves. When municipal pension monies are used for low-interest mortgages, among those benefiting from such mortgages are the pension plan participants who live in the city and who take mortgages from the plan. If our hypothetical university makes the requested loan to the proposed developer, one of the adjoining property owners whose real estate will benefit will be the university itself.

A social investment that takes place in the fiduciary's backyard may yield some of its "social" advantage to the fiduciary's beneficiary. It is this type of investment that I would label the "local" social investment in contradistinction to the "global" social investment.

Admittedly, the distinction is often one of degree: if the university were asked to fund a project three miles from its campus and real estate holdings, the university would still derive some of the social

Investing Plan Assets in Mortgages, 10 *Pens. Rep. (BNA)* No. 437, at 552, 552 (Mar. 28, 1983); Financial Institutions Show Interest in Socially Responsive Investing, 14 *Sec. Reg. & L. Rep. (BNA)* No. 40, at 1752, 1753 (Oct. 15, 1982).

¹⁸ See *infra* notes 19-25 and accompanying text.

benefit, though perhaps not as much as it would derive from a project immediately adjacent to the campus. A project ten miles away might generate even less social benefit for the university. Although the difference is often one of degree rather than kind, the distinction between local and global social investments remains a useful one.

III. THE LEGAL FRAMEWORK GOVERNING FIDUCIARY INVESTMENT DECISIONS: A BRIEF REVIEW

Historically, the supervision of fiduciaries was a task performed by the courts of equity. Consequently, our oldest sources of fiduciary jurisprudence are the case law criteria that outline the traditional responsibilities of trustees and executors.¹⁹

Because of the possibilities for abuse inherent in the fiduciary's position, the courts of equity protected the interests of the beneficiary by imposing certain affirmative duties on the fiduciary and proscribing other actions inimical to the welfare of the beneficiary.²⁰ Even today, the executor of an estate or the trustee of a private trust remains the classic fiduciary, holding and managing property for the benefit of someone other than himself.

The courts of equity performed two major tasks when they defined the obligations of the fiduciary. First, they postulated that the fiduciary's prime responsibility is to his beneficiary. The fiduciary must avoid even the appearance of violating that responsibility and must avoid enriching himself at his beneficiary's expense.²¹ Second, the courts indicated that the fiduciary must protect the assets under his control through prudent investment decisions that result in the diversification of those assets and that achieve a reasonable rate of

¹⁹ For the classic common law case, see *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830).

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.

Id. at 461. The responsibilities of the modern trustee are most often described in the trust instrument. In the absence of such explicit delineation, those responsibilities are generally comprised of the duty of loyalty and the duty not to delegate, to keep and render accounts, and to exercise reasonable skill and care in the administration of the trust. 2 A. Scott, *The Law of Trusts* § 164, at 1254-55 (3d ed. 1967).

²⁰ For example, in the absence of express provisions in the trust instrument, courts of equity have imposed certain duties, such as the duty of loyalty, while proscribing certain activities such as selling land, chattels, and securities, or borrowing money from the trust. 2 A. Scott, *supra* note 19, § 164, at 1254, 1256.

²¹ G.G. Bogert & G.T. Bogert, *The Law of Trusts and Trustees* § 541, at 157 (rev. 2d ed. 1977).

return. The fiduciary is to diversify and make productive the assets under his control because that is how the prudent man manages his own investments.²² The fiduciary's beneficiaries are entitled to nothing less.

Hence, a trustee who receives trust property consisting solely of cash must, absent special permission from the grantor, diversify his holdings into other types of investments. He cannot keep excessive amounts of monies in noninterest bearing accounts, since the beneficiaries are entitled to have the assets of the trust invested in a productive manner.²³ Indeed, an executor will have difficulty justifying the retention of cash balances in low-interest accounts for an unreasonable period of time.²⁴

In the twentieth century, the courts have extended the traditional rules of fiduciary law to nontraditional fiduciaries, for example, to the trustees of private foundations and universities.²⁵

The decisions of the North Carolina Supreme Court regarding the Duke Endowment are the leading cases involving the charitable trustee's duty to diversify and maximize trust assets.²⁶ They also highlight the increasing federalization of fiduciary regulation through the Internal Revenue Code and other federal statutes. Somewhat ironically, these decisions arose not from a situation in which the trustees failed to diversify or seek a high rate of return, but from one in which the grantor of the charitable trust forbade them to do so.

In 1924, James B. Duke created a charitable trust known as the Duke Endowment. In the indenture creating the endowment, Duke

²² *Id.* § 612, at 18-20.

²³ 2 A. Scott, *supra* note 19, § 181, at 1463.

²⁴ *Id.* § 180.3, at 1457.

²⁵ See G.G. Bogert & G.T. Bogert, *supra* note 21, § 391, at 206-07; e.g., *Rand v. McKittrick*, 346 Mo. 466, 142 S.W.2d 29 (1940) (trustees of private hospital held to traditional standard of fiduciary care). For a recent application of the traditional fiduciary law in the context of a pension plan, see *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979). In *Withers*, the trustees of a New York City municipal pension plan invested pension funds in "highly speculative" New York City bonds. Some beneficiaries of the plan contended that the trustees violated their fiduciary duty by purchasing the bonds and by investing with the objective of rescuing the city from bankruptcy instead of enhancing the fund. In holding that the trustee's decision to invest in New York City bonds was prudent in light of the fact that the city was the major contributor and guarantor of the funds, the court reiterated the traditional responsibility of fiduciaries to exercise prudence in the care of the funds entrusted to them: "The classic statement of the 'prudent man rule' in New York is that 'the trustee is bound to employ such diligence and such prudence in the care and management [of the fund], as, in general, prudent men of discretion and intelligence in such matters, employ in their own affairs.'" *Id.* at 1254 (quoting *King v. Talbot*, 40 N.Y. 76, 85-86 (1869)).

²⁶ See *Davison v. Duke Univ.*, 282 N.C. 676, 194 S.E.2d 761 (1973); *Cocke v. Duke Univ.*, 260 N.C. 1, 131 S.E.2d 909 (1963).

designated Duke University and a variety of eleemosynary institutions in North and South Carolina as the recipients of the trust's income. Duke further provided that the trustees were generally to invest the endowment's assets in the securities of, or loans to, the Duke Power Company or one of its subsidiaries. Under limited circumstances, the trustees could invest assets in specified types of government bonds. Other types of investments were generally forbidden.²⁷

By 1961, the trust owned stocks and bonds of the Duke Power Company worth \$393,695,928. The trustees owned 57% of the voting stock of the Duke Power Company. Seven of the sixteen directors of the Duke Power Company were trustees of the endowment. These stocks and bonds constituted, by value, over 80% of the endowment's assets.²⁸

The trustees, concerned about the undiversified nature of the trust's portfolio, petitioned the North Carolina courts to amend the trust indenture to permit investments in stocks and bonds other than those of the Duke Power Company and its subsidiaries. The lower court, impressed by the testimony of "investment experts" that "a greater degree of diversification is necessary, under general trust investment principles," acceded to the trustees' request and modified the indenture to provide for a broad range of investments. The court concluded that the situation in which the trust found itself constituted an "emergency" justifying the judicial modification of the trust indenture.²⁹

The Supreme Court of North Carolina disagreed. It may ordinarily be, the court noted, "that a prudent person does not carry all his eggs in one basket."³⁰ James B. Duke, however, was no ordinary person. The creator of the American Tobacco Corporation, Duke was a giant of industry on a par with John D. Rockefeller and Andrew Carnegie. The provisions of the trust indenture were carefully and deliberately developed by Duke and his attorney. The Supreme Court would not interfere with Duke's considered decision to restrict the trustees to an undiversified portfolio. The lower court was reversed.³¹

The saga, however, did not end there.

After the Tax Reform Act of 1969³² added section 4943 to the Internal Revenue Code, the trustees were confronted with the neces-

²⁷ *Cocke v. Duke Univ.*, 260 N.C. 1, 6, 131 S.E.2d 909, 911-12 (1963).

²⁸ *Id.* at 13, 131 S.E.2d at 916.

²⁹ *Id.* at 14, 131 S.E.2d at 917.

³⁰ *Id.* at 20, 131 S.E.2d at 921.

³¹ *Id.* at 22, 131 S.E.2d at 922.

³² Pub. L. No. 91-172, 83 Stat. 487, reprinted in 1969 U.S. Code Cong. & Ad. News 509, 532-37.

sity of divesting themselves of some of the endowment's Duke Power stock or paying penalty taxes for excess business holdings.³³ Section 4943 generally forbids private foundations from holding controlling interests in corporations and businesses.³⁴ The adoption of section 4943 thus forced the trustees to sell some of their Duke Power stock. The indenture required the trustees to invest the proceeds of that stock in government obligations. Constrained by these restrictions, the trustees argued that the trust's already poor investment performance would deteriorate further.³⁵

This time the North Carolina Supreme Court agreed with the trustees and authorized them to invest trust assets in a wide range of stocks and bonds. The passage of section 4943 was viewed by the court as enough of an emergency to override James Duke's restrictions on the trustees' investment powers.³⁶

The Duke Endowment cases reflect the historic framework governing charitable fiduciaries. The authorities relied upon by the North Carolina courts were the case law decisions defining the rules pertaining to private trusts. These cases impose a basic duty to diversify and make productive the assets held by charitable fiduciaries. The charitable trustee, like the private trustee, must treat the funds confided to him as the prudent man would treat his personal resources.

The fiduciary obligations established by the courts have, in many situations, been statutorily reinforced and elaborated upon by Congress. Congress grants exemptions from and deductions for federal tax purposes, in order to encourage certain types of institutions Congress deems worthy of financial support.³⁷ In effect, the federal fisc subsidizes these institutions by declining to tax their income and by reducing the tax of those who contribute to these institutions.³⁸ To ensure that federal support of eleemosynary institutions achieves its

³³ I.R.C. § 4943; see *infra* notes 43-46 and accompanying text.

³⁴ I.R.C. § 4943(c); see *infra* notes 43-46 and accompanying text.

³⁵ *Davison v. Duke Univ.*, 282 N.C. 676, 194 S.E.2d 761 (1973).

³⁶ *Id.* at 694-95, 194 S.E.2d at 772-73.

³⁷ See *supra* note 12 and accompanying text.

³⁸ See *Regan v. Taxation With Representation of Wash.*, 103 S. Ct. 1997 (1983):

Both tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income. Deductible contributions are similar to cash grants of the amount of a portion of the individual's contributions. The system Congress has enacted provides this kind of subsidy to nonprofit civic welfare organizations generally, and an additional subsidy to those charitable organizations that do not engage in substantial lobbying.

Id. at 2000 (footnote omitted).

intended objectives, Congress has imposed responsibilities upon the fiduciaries who control these institutions. Not surprisingly, these fiduciary duties bear a close resemblance to the traditional obligations of loyalty, productivity, and diversification outlined by the courts of equity.

Particularly strict is the regulation, by Congress, of the fiduciaries of private foundations. Under Code section 4941, such fiduciaries are generally forbidden to sell or lease property to their foundations; to exchange property with their foundations; to borrow from, or lend to, their foundations; to provide goods, services or facilities to their foundations; or to otherwise use or benefit from the foundations' assets.³⁹ Congress' rationale for these proscriptions was that fiduciaries should not be permitted to benefit from their foundations. An absolute prohibition on dealings between foundations and fiduciaries is the only effective means of policing fiduciary behavior.⁴⁰ A fiduciary who violates the proscriptions of section 4941 is subject to a personal penalty tax.⁴¹

Imprudent investments by private foundation fiduciaries are similarly prohibited by Congress. Under section 4944, the fiduciary who knowingly participates in such an investment is subject to personal liability.⁴²

Section 4943, at issue in the second of the Duke Endowment decisions, imposes a specific type of diversification requirement upon private foundations. Under section 4943, a private foundation generally may not own more than 20% of the voting interest in any business.⁴³ Under certain circumstances, the Treasury may permit ownership of up to 35% of the voting interest of a business.⁴⁴ Foundations that hold assets in excess of these limits are subject to penalty taxes.⁴⁵ While the foundation's fiduciaries are not subject to personal

³⁹ I.R.C. § 4941.

⁴⁰ For a discussion of the history and origin of Section 4941, see Zelinsky, Section 4975 and PTE 77-9: The Causes of Complexity in the Internal Revenue Code, 15 U.C.D. L. Rev. 1, 7-19 (1981).

⁴¹ I.R.C. § 4941(a), (b). "Section 4941 provides for an initial penalty as a result of the prohibited transaction itself. If the transaction is not remedied within a specified 'correction period,' an additional, heavier tax is placed upon the culpable disqualified person." Zelinsky, *supra* note 40, at 17.

⁴² I.R.C. § 4944(a)(2).

⁴³ *Id.* § 4943(c)(2)(A).

⁴⁴ *Id.* § 4943(c)(2)(B).

⁴⁵ Section 4943 imposes a tax equal to 5% of the value of excess business holdings of any private foundation during the taxable year. *Id.* § 4943(a)(1). Where an initial tax is imposed under subsection (a), and at the close of the taxable period the foundation still has excess business holdings in that enterprise, there is an additional tax equal to 200% of the value of the excess holdings. *Id.* § 4943(b).

liability under section 4943, that provision nevertheless constrains their behavior since any penalty taxes paid by the foundation would, as a matter of state law, reflect on the fiduciaries' handling of the foundation's affairs.⁴⁶

Just as Congress viewed private foundations as tax-subsidized institutions whose fiduciaries are appropriately subject to federal regulation, Congress has imposed statutory restrictions on the fiduciaries of profit-sharing and pension plans. Section 4975, modeled after section 4941, generally prohibits the fiduciaries of pension and profit-sharing plans from selling or leasing property to their plans; from exchanging with their plans; from engaging in loan transactions with their plans; from furnishing to, or receiving from, their plans goods, services, and facilities; and from using, or benefiting from, the assets of their plans.⁴⁷ Fiduciaries who engage in these prohibited transactions are subject to personal penalty taxes.⁴⁸

The Internal Revenue Code further conditions the tax-exempt status of pension and profit-sharing plans upon the use of plan assets for "the exclusive benefit" of plan participants and beneficiaries.⁴⁹ As we shall see below, the exclusive benefit rule has in practice served as a restraint on the misuse of plan assets by fiduciaries and has been interpreted as embodying the prudent man requirements of productivity and diversity.⁵⁰

Indeed, the Employee Retirement Income Security Act of 1974 ("ERISA")⁵¹ effected the wholesale federalization of the fiduciary obligations of pension and profit-sharing trustees. In addition to section 4975, ERISA imposed upon all such trustees a federally enforceable obligation to invest pension and profit-sharing assets in a prudent and productive manner.⁵² ERISA further imposed on plan trustees an explicit duty to diversify plan assets.⁵³ Violation of these statutory restraints may be challenged judicially by the Department of Labor or

⁴⁶ On the practical effects of § 4943, see *Foundation Sells 19 Buildings For \$400 Million in Divestiture*, N.Y. Times, Jan. 19, 1984, at D23, col. 1; *Chicago Philanthropy Balks at Sale of Assets*, N.Y. Times, Nov. 28, 1983, at B11, col. 2.

⁴⁷ I.R.C. § 4975.

⁴⁸ *Id.* § 4975(a), (b). "Section 4975 replicates the two tier tax scheme of section 4941, imposing a first tier tax on the prohibited transaction and a second tier tax if the transaction is not corrected after the exercise of judicial and appellate review." Zelinsky, *supra* note 40, at 23.

⁴⁹ I.R.C. § 401(a)(2). See *supra* note 12.

⁵⁰ See *infra* notes 66-71 and accompanying text.

⁵¹ Pub. L. No. 93-406, 88 Stat. 829, reprinted in 1974 U.S. Code Cong. & Ad. News 935 (codified as amended at 29 U.S.C. §§ 1001-1145 (1982)).

⁵² 29 U.S.C. § 1104(a)(1)(B) (1982).

⁵³ *Id.* § 1104(a)(1)(C).

by plan participants and beneficiaries.⁵⁴ A fiduciary found to have violated his ERISA obligation to invest prudently and diversely may be removed from his position and may be required to make restitution for his breach of duty.⁵⁵

In *Freund v. Marshall & Ilsley Bank*,⁵⁶ the Secretary of Labor and the participants of a pension plan challenged the investment practices of the plan's fiduciaries as violative of the ERISA-imposed duty to diversify and invest prudently. The defendant fiduciaries, rather than placing plan assets in stocks, bonds, or similar properties, had loaned "virtually all of the [p]lan's assets" back to the companies sponsoring the plan.⁵⁷ In return, the fiduciaries took unsecured promissory notes from those companies. Hence, the plan's portfolio consisted almost exclusively of notes from the sponsoring employers.⁵⁸

The district court, not surprisingly, characterized this practice as a "complete failure to diversify"⁵⁹ and ordered the removal of the defendant fiduciaries and the appointment of a new trustee.⁶⁰

A somewhat more subtle situation was at issue in *Marshall v. Glass/Metal Association & Glaziers & Glassworkers Pension Plan*,⁶¹ which also arose under the ERISA fiduciary statutes. There, the Secretary of Labor sought to enjoin, on diversification and prudence grounds, a loan by a pension plan before the loan was consummated. The trustees proposed to lend 23% of the plan's assets to a company intending to develop a time-sharing vacation project to be marketed to local residents. The project had already been suspended once for financial and economic reasons. Moreover, the court found that the "marketing concept" animating the project "was completely untried."⁶² In light of these "special risks," the court concluded that the proposed loan, if actually made, would violate the trustees' obligation to diversify. Accordingly, the court enjoined the trustees from making the loan.⁶³

Similarly, in *Marshall v. Teamsters Local 282 Pension Trust Fund*,⁶⁴ the court, at the instigation of the Secretary of Labor, enjoined pension trustees from making a contemplated loan to finance a

⁵⁴ Id. § 1132(a).

⁵⁵ Id. § 1109(a).

⁵⁶ 485 F. Supp. 629 (W.D. Wis. 1979).

⁵⁷ Id. at 636.

⁵⁸ Id.

⁵⁹ Id.

⁶⁰ Id. at 644.

⁶¹ 507 F. Supp. 378 (D. Hawaii 1980).

⁶² Id. at 382.

⁶³ Id. at 384-85.

⁶⁴ 458 F. Supp. 986 (E.D.N.Y. 1978).

hotel and casino in Las Vegas. Finding that the proposed loan would have utilized 36% of the plan's funds, the court characterized the loan as "a disproportionate commitment" of the plan's assets and therefore a violation of the trustees' duty to diversify.⁶⁵

The specific details of *Freund, Glass/Metal*, and *Teamsters Local 282* are of less importance than the explicit federalization of the duty to diversify and invest prudently which they represent. However, even prior to the adoption of ERISA, the IRS took the position that the exclusive benefit rule of the Internal Revenue Code imposes upon pension and profit-sharing trustees the duty to diversify the assets under their control and to make those assets productive. In Revenue Ruling 69-494,⁶⁶ the IRS stated that an investment by a pension plan is consistent with the exclusive benefit rule only if, in addition to meeting other requirements, the investment results in a reasonable rate of return and the "diversity that a prudent investor" would insist upon. Subsequently, in Revenue Ruling 73-380,⁶⁷ the IRS held that a loan by a plan of "substantially all" of its assets to the sponsoring employer violated the exclusive benefit rule because of the consequently undiversified nature of the plan's portfolio.⁶⁸

The IRS' interpretation of the exclusive benefit rule was embraced by the Court of Appeals for the Tenth Circuit in *Central Motor Co. v. United States*.⁶⁹ In *Central Motor*, the employer corporation (Central Motor) was controlled by one Mr. Gurley. Substantially all of the assets of the Central Motor pension plan were loaned to a second company, Credit Investment. Credit Investment was controlled by Mr. Gurley, his son, and his son-in-law.⁷⁰

On these facts, the court, accepting the teaching of Revenue Ruling 69-494, agreed that the plan violated the exclusive benefit rule because of its failure to diversify.⁷¹

For the purposes of this Article, one major conclusion emerges from this brief review. In all four of our examples—the university, the state's pension plan, the church organization's pension plan, and the construction company's profit-sharing plan—the fiduciaries are legally bound to invest prudently, productively, and diversely. For some of these fiduciaries, the exclusive or primary sources of their obligations are federal statutes. For other fiduciaries, their duties

⁶⁵ Id. at 992.

⁶⁶ 1969-2 C.B. 88.

⁶⁷ 1973-2 C.B. 124.

⁶⁸ Id. at 124-25.

⁶⁹ 583 F.2d 470 (10th Cir. 1978).

⁷⁰ Id. at 490.

⁷¹ Id. at 490-91.

emerge from a mixture of federal and state authorities. In substance, however, all confront essentially the same obligation to invest productively and diversely.

IV. THE CONCEPT OF THE EXTERNALITY

As Professor Fellner has indicated, externalities are said to arise "when the production of a good or service creates benefits elsewhere in the economy, benefits which are external to the buyer-seller relations accompanying the act of production."⁷² Just as the notions of prudence, productivity, and diversification play a central role in fiduciary law, the concept of the externality is critical to contemporary microeconomic theory.⁷³

For the theorists of the market, the existence of externalities creates a problem. In the absence of externalities, a free market will, in conception at least, result in the maximization of the economic welfare of those participating in the market.⁷⁴ X will consume apples to the point where the cost of producing apples is justified by the increase the apples make upon X's sense of well-being. In the language of contemporary microeconomics, X will consume apples until his marginal utility from apples equals the price at which he must buy them. X, of course, knows that point better than anyone else and should, therefore, be allowed to move to it on his own and without interference from others. Hence, X should be free to consume as many (or as few) apples as he wants.⁷⁵

Suppose, however, we are not dealing with goods like apples, which, when consumed, do not benefit X's neighbor, Y. Suppose instead we are discussing a good that, when consumed by X, affects Y—e.g., the painting of the outside of X's house. X, if left to his own devices, will improve the outside of his house to the point where the

⁷² W. Fellner, *Emergence and Content of Modern Economic Analysis* 117 (1960).

⁷³ See, e.g., *id.* at 116.

⁷⁴ This maximization of resources is derived from the concept of pareto-optimality. A pareto-optimum situation is said to exist when "it is not possible to reallocate resources so as to improve the well-being (or utility) of one person without making at least one other person worse off (i.e., reduce their utility)." R. Boadway, *Public Sector Economics* 5 (1979). In a perfectly competitive economy, the free market will "lead to an efficient or [p]areto-optimal allocation of resources." *Id.* at 29.

In the real world, however, the conditions necessary for efficient markets will rarely, if ever, exist. The market mechanism will fail to allocate resources efficiently due to the existence of factors such as externalities, see *infra* note 76 and accompanying text, public goods, increasing returns to scale, risk and uncertainty, and tax distortions. See R. Boadway, *supra*, at 29-40.

⁷⁵ For what some would consider the classic contemporary statement of this view, see G. Stigler, *The Theory of Price* (3d ed. 1966).

cost of improvement is justified by X's sense of the resulting increase in his welfare. However, the improvement of the exterior of X's house gives rise to externalities that benefit X's neighbor, Y. The value of Y's house increases with the upgrading of X's adjoining property. To put it another way, when X improves his property, he creates secondary benefits for Y.

However, X will generally not be concerned with Y's welfare. Though additional improvements to X's house are beneficial for Y, X has no financial incentive to proceed with these improvements. In theory, Y can reimburse X for the cost of improving X's house and, indeed, Y will have a financial incentive to do so. The externalities that benefit Y justify the expenditure by Y of some funds to secure those benefits.⁷⁶

What happens, however, when X is surrounded by ten other homeowners in addition to Y? The bilateral reimbursement of X by Y becomes an inadequate response to the situation. Y will expect the other neighbors to pay for the externalities from which they benefit. Negotiations between so many property owners are likely to be time consuming and, possibly, unproductive. Hence, governmental intervention (e.g., housing codes, subsidies, tax abatements) may be necessary to motivate X to make investments in his house that will impact favorably on Y and the other neighbors.⁷⁷

⁷⁶ An externality exists where the actions of one party affect the utility or production possibilities of another without being priced. "The fact that it is not priced implies that the 'emitting' party has no incentive to take into consideration the effect, beneficial or detrimental, on the 'affected' party. That being the case, the emitting party may devote an inefficient amount of resources to pursuing the activity." R. Boadway, *supra* note 74, at 91. In order to arrive at pareto-optimality, the emitting party must consider not only the benefit that he will derive from the activity, but also the benefit (or detriment) that will be incurred by the affected party. Thus, a voluntary reimbursement will "internalize" the externality, and a pareto-optimal allocation of resources will be achieved.

⁷⁷ Theoretically, X and Y can bargain with each other until the desired level of output is achieved. Y will have the incentive to reimburse X in order to maximize his own utility. See *supra* note 76 and accompanying text. However, excessive transaction costs may preclude the parties from reaching agreement on an optimal allocation of resources. R. Bish & H. Nourse, *Urban Economics and Policy Analysis* 114 & n.5 (1975). Similarly, with a large number of property owners, the voluntary compensation of X becomes more complicated. It may be impossible, or at the least very costly, to prevent the adjoining property owners from reaping the benefit of X's activity. Since a voluntary price may not be enforceable, the adjoining property owners will have an incentive to consume the activity free of charge. This failure of the free market system is commonly known as the free rider problem. R. Boadway, *supra* note 74, at 31.

The failure of the market to allocate resources efficiently has been presented as a justification for governmental intervention. R. Bish & H. Nourse, *supra*, at 115; R. Boadway, *supra* note 74, at 31. Since a voluntary price mechanism may be unsuccessful in achieving pareto-optimality, some kind of coercive device must be implemented in order to provide the parties with the incentive to take into account the external effects of the activity. Taxation, subsidies,

The example of X and Y as adjacent homeowners suggests why the concept of the externality has not played an important role in traditional fiduciary law. X and Y generate externalities because of their proximity to one another. Such proximity is obviously a function of urbanization. If X's house is a rural farmhouse, surrounded by acres of corn, the painting of X's house will generate externalities for no one. Since much of our fiduciary law traces its roots to preurbanized days, the externalities, so obvious in a modern age, were generally absent when that law was in its formative stages.⁷⁸

Nevertheless, the fiduciary's obligation to make the assets confided to him productive should be defined as an obligation to make productive those assets accounting for all externalities affecting the fiduciary's beneficiary. The reason for formulating the fiduciary's duties in this fashion is straightforward. The fiduciary's obligations are designed to emulate the prudent investor in the handling of his personal affairs.⁷⁹ Even if the prudent investor has never heard the term "externalities," he knows they exist and he accounts for them in his investment decisions. What prudent owner of urban or suburban real estate does not recognize and concern himself with the condition of adjoining parcels? As the goal of fiduciary law is to require fiduciaries to behave like prudent men, fiduciaries should explicitly be required to recognize the existence of externalities.

V. THE LOCAL SOCIAL INVESTMENT IN CONTEXT: A CLOSER LOOK AT FOUR EXAMPLES

Against this background, we can examine the proposals advanced to our hypothetical university and to our pension and profit-sharing plans. This examination will confirm my central observation that, because of its externalities, the local social investment will often be highly productive. However, because of its local nature, it will generally be among the least diversifying investments available to the fiduciary. Hence, one traditional criterion of fiduciary law (rate of return) will frequently impel the making of the local social investment while another criterion (diversification) will often forbid it.

The benefits of the city's proposal to the university are, at first blush, clear. In addition to the direct cash return from the proposed mortgage, the university's downtown real estate holdings should increase in value as a result of the projected redevelopment activity. As

and allocation of property rights are examples of government practices that attempt to correct market failure. *Id.* at 111-20.

⁷⁸ See, e.g., *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830).

⁷⁹ See *supra* notes 19-25 and accompanying text.

the university owns a significant portion of downtown real estate, its holdings will receive a substantial part of the externalities generated by the redevelopment activity. We can, therefore, say with reasonable confidence that the rate of return on the proposed mortgage will be in excess of 8% once we acknowledge the benefits of this investment to the university's downtown holdings.

Indeed, we can reasonably conclude that the rate of return on this ostensibly social investment may eventually equal or surpass that of more conventional opportunities available to the university. The difference in direct return between the proposed mortgage and alternative investments is \$200,000 per year—the 2% difference between an 8% return on \$10 million and a 10% return on that same amount. If we modestly assume that the university's downtown holdings will appreciate on an annual basis by an extra 0.4% as a result of the proposed project, then the extra appreciation of \$200,000 per year equalizes the rate of return of the proposed mortgage with the return on more conventional investments.⁸⁰ Indeed, if we assume that the extra appreciation of the university's holdings will constitute 0.5% per year, the rate of return on the social investment will actually exceed that on more conventional assets.⁸¹

This analysis only focuses upon the externalities to be derived by the university's investment holdings in the downtown area. The university, however, owns a second type of real estate that will benefit from the proposed project. The campus, or more precisely the portion that adjoins downtown, will also benefit from the improvement of the downtown area. The campus may be viewed by the university as an economic asset, potentially saleable or available to collateralize loans to the university. If so, the rate of return on the proposed mortgage, adjusted to reflect the additional externalities upon the university's campus real estate, may go even higher.

Hence, if we look only at the rate of return, the proposed social investment is potentially attractive for the university whether or not the university wants to help the city. The university's own interests, if defined as the rate of return, are potentially sufficient to impel the university to extend the proposed mortgage.

However, while the proposed mortgage may be a good investment in terms of its rate of return, it is difficult to imagine a less di-

⁸⁰ It was hypothesized that the university has holdings in downtown Westville that are worth \$50 million. See *supra* text accompanying note 5. An extra 0.4% of annual appreciation on \$50 million is \$200,000.

⁸¹ Extra annual appreciation of 0.5% on the university's \$50 million holdings in downtown Westville would amount to \$250,000 per year. This more than compensates for the \$200,000 the university will forego by extending the lower interest mortgage.

verse investment for the university. The university's economic fortunes are already heavily tied to those of Westville. Of the university's endowment dollars, one in six is already invested in downtown Westville and the university's campus represents an additional \$100 million investment in the town. Thus, over 37% of the university's wealth is tied up with the fate of Westville.⁸² The proposed mortgage would further entwine the university's financial fortunes with those of Westville. From the viewpoint of diversification, the proposed mortgage is a bad deployment of the university's resources.

It is useful to contrast the mortgage proposed to the university by the city with the demand that the university divest itself of military-related stocks. That demand, if acceded to by the university, would reduce the range of investments available to the university. However, even if the university divested itself of the stocks of all companies that derive substantial income from military sales, it could still select from many issues listed on the New York and American exchanges. The university would still be able to invest in blue chip and growth stocks. While the university's discretion to purchase stocks would be narrowed, it could still maintain a fairly diversified portfolio.

On the other hand, a military-sensitive investment policy would not generate any secondary economic benefits like the externalities of the mortgage proposal for the university's real estate. If the movement of assets from military-based industries to nonmilitary investments will lower the cash rate of return (and the university's advisors think that it might), the university will indeed suffer economically as a result of the decision to divest military-based stocks.

In short, though both the mortgage proposal and the demand to divest military stocks are commonly styled social investments, they pose significantly different choices for the university in terms of diversification and rate of return.

The dilemma of the local social investment reappears when we examine the proposal to the profit-sharing trustees of the home construction company. If implemented, the proposal to invest profit-sharing assets in low-rate mortgages will generate two externalities for the plan and its participants: additional mortgage money will mean more home construction and thus more work for plan participants. More home construction in Elmtown should also increase corporate profits and thus increase contributions to the corporation's profit-sharing plan.

⁸² The university's assets total \$400 million: its \$100 million campus and its \$300 million endowment. The campus and the university's downtown holdings represent \$150 million of this \$400 million, or 37.5% of the total.

Looking at the rate of return, it is not difficult to conclude that plan participants may be better off if the proposal to the trustees for home mortgage loans is accepted. Let us assume, for example, that the typical participant has a balance of \$10,000 in the plan. Hence, \$1,000 of his profit-sharing funds will be invested in the mortgage program at a return 2% less than the return otherwise obtainable.⁸³ The local social investment initially "costs" this participant \$20, representing the first year's lower return on \$1,000 of his profit-sharing funds. Over the course of three years, the local social investment results in a direct cash return \$60 less than the participant would otherwise receive.⁸⁴

However, if the mortgage program is successful, the corporation will contribute additional funds to his profit-sharing account. If this additional contribution comes to \$60, the participant's account will be fully restored to the level it would have attained at market rates. If the additional contribution to the participant's account exceeds \$60, the participant has, paradoxically, made money through the low-rate investment.

Moreover, these calculations ignore what the participants may consider the most important externality: work or, more precisely, the additional income each participant will receive as a result of the additional work generated for him by the mortgage program.

However, the trustees must confront the question of diversification. Here again we see the problem of the local social investment. The financial fates of the plan and of its participants are already entwined with the economy of Elmtown in general, and Elmtown's housing market in particular. Making the plan a mortgagee of Elmtown real estate further ties the fortunes of the plan to those of Elmtown. The absence of diversification would become particularly acute if the plan, as mortgagee, were forced to foreclose on any of the homes it had financed. The plan, in attempting to sell these existing homes, could find itself competing with the corporation and its efforts to encourage new housing construction.

The solar-based investment urged upon the trustees by local environmental groups also entails certain disadvantages. The securities of any new company must be considered risky. When the company's product is of an experimental nature, the risks must be considered even greater. Whatever the prospects for long-term growth in the solar-equipment industry, it is unlikely that the securities proposed to

⁸³ The funds to be invested in low-rate mortgages represent one-tenth of the plan's current assets. See text accompanying note 6.

⁸⁴ That is, the participant will earn 2% less on \$1,000, i.e., \$20, for three years.

the trustees will generate significant returns in the company's early years.

Nevertheless, the environmentalists' proposal has one great advantage over the mortgage plan: the environmentalists' investment would diversify the trustees out of the homebuilding market and the Elmtown market in particular. As we have seen, the mortgage proposal would subject the profit-sharing plan to a form of economic double jeopardy. Corporate profits and thus profit-sharing contributions are already at the mercy of the Elmtown housing market. The mortgage proposal would further tie the plan's economic fate to Elmtown housing by making the plan a mortgagee of part of that housing.

In contrast, the corporation advocated by the environmentalists will make solar equipment for use in sections of the country other than Elmtown. Moreover, that equipment is industrial rather than residential in nature. Whatever the overall merits of the two social investments advanced to our hypothetical profit-sharing trustees, the mortgage proposal is clearly inferior to the solar proposal from the viewpoint of diversification.

At first blush, it appears that the participants in the church organization's defined benefit pension plan would be indifferent to the social investment proposals advanced to the plan's trustees. Because the plan is of the defined benefit variety, each participant is guaranteed a specific retirement benefit. If the plan's investment performance is inadequate to provide the promised benefit, the employer organization must make up the difference from its own funds.⁸⁵ Moreover, the insurance provided by the PBGC guarantees a federally determined level of pension benefits for each participant.⁸⁶ Consequently, plan participants probably would not care how the trustees invest the funds confided to them.

On further reflection, however, the matter is not so clear. The PBGC currently insures only about \$15,000 of each participant's annual pension benefit.⁸⁷ While this figure will rise with the cost of living, a portion of retirement benefits for higher paid employees may never be guaranteed by the PBGC. For example, the plan promises a senior employee currently making a salary of \$80,000 per year an annual retirement pension of \$48,000.⁸⁸ Less than half of this benefit

⁸⁵ See *supra* note 8.

⁸⁶ See *supra* note 9.

⁸⁷ See PBGC News Release, 4 Pens. & Profit Sharing (P-H) ¶ 135,520 (Dec. 10, 1980) (the maximum pension guaranteed for plans that terminated in 1981 was \$1,261.36 per month; however, the average monthly benefit paid was substantially less).

⁸⁸ The participant's projected benefit is 60% of his final salary, which now looks like \$80,000.

would be insured by the PBGC in the case of employer default.

Moreover, the prospects of employer default cannot be dismissed lightly. A plan participant currently in his early thirties must wait approximately three decades to receive his pension benefit. It is almost impossible for him to predict with any confidence what the organization's financial capacity will be at the time of his retirement. It is quite possible that the employer's commitment to make good on the promised benefit may not be worth much thirty years from now.⁸⁹

The nature of the employer ought to engender some concern on the part of the plan participant. He is, after all, not working for a blue chip industrial giant but for a voluntary, nonprofit organization, which, in the past, has seen significant fluctuations in membership and income. The employer's guarantee of the participant's projected benefit necessarily relies on the organization's ability to attract and retain dues-paying churches.

The plan participant should be concerned about the employer's financial position in one other respect. Lower investment returns by the trustees will increase both the immediate and long-term liability of the employer to make up the difference between the funds in the plan and the funds needed to provide the plan's promised benefits. If the organization's actual or potential liability under the pension plan becomes too great, it might respond by either terminating the plan, or by freezing current salaries and thus freezing plan benefits. Either alternative, of course, would have an adverse impact upon plan participants.

In short, the plan participants, particularly those with benefits projected in excess of the level guaranteed by the PBGC, have a significant interest in the employer's financial condition and the trustees' investment performance. The proposal to extend below market rate mortgages to churches in poor areas should be evaluated in that light.

In view of the organization's history, the mortgage proposal may be a desirable one for the plan's participants. The externality here—the churches' commitment to affiliate and pay dues for the ten years—strengthens the value of the organization's guarantee of the benefit promised by the plan. As we saw, that guarantee is no better than the organization's own financial strength. By bolstering the income of the church organization for a ten-year period, the mortgage proposal en-

⁸⁹ The Multiemployer Pension Plan Amendments Act of 1980, Pub. L. No. 96-364, 94 Stat. 1208, was, in large measure, a response to the PBGC's meager resources relative to the enormous unfunded pension liabilities which exist in multiemployer plans. See H.R. Rep. No. 869, 96th Cong., 2d Sess. 52-57, reprinted in 1980 U.S. Code Cong. & Ad. News 2918, 2920-25.

hances the probability that the promised benefit will be paid if the organization must provide the benefit out of its own funds.

However, serious questions must be asked about the mortgage proposal under the heading of diversification. The financial well-being of the plan participants is already closely tied to the economic welfare of the churches affiliated with the organization. If those churches experience a decline in membership or financial hardship that impedes the regular payment of dues, the organization's income will suffer, with evident consequences for the employees, their salaries, and the organization's ability to pay pension contributions. The proposal to extend mortgages to affiliated churches compounds the participants' vulnerability to the churches' fortunes. If the mortgagor-churches experience difficult times, not only will they have trouble making significant payments to the organization, but in all likelihood they will have trouble paying their mortgages as well. Plan participants could thus lose doubly from declines in the fortunes of the participating churches, once because of reduced membership income, and a second time because of mortgage default.

Moreover, if mortgage default reflects the further economic deterioration of the areas in which the mortgagor churches are located, the plan's position may be seriously imperiled. Compelled to foreclose, the plan could find that those church buildings are of little resale value.

We can contrast the mortgage proposal to the church organization's trustees with the suggestion that the trustees divest stocks in companies conducting business directly or indirectly with South Africa and then reinvest the proceeds in companies without such contacts. The latter proposal will not generate any externalities for the plan: there are no secondary economic benefits from the proposed divestiture and reinvestment in firms that do not do business in South Africa.

However, the anti-apartheid proposal results in greater diversification for the plan and its participants than does the proposal to extend mortgages to churches in low income areas. The fate of the plan is tied substantially to the ability of these churches, which pay dues to the national organization, to attract and retain members. The mortgage proposal would further entwine the interests of the plan and its participants with the fortunes of these churches. By contrast, if the plan invests some of its assets in companies because of their noninvolvement in South Africa, there will be no external effect on the plan. The performance of these companies will only affect the growth, or lack thereof, of the plan's assets. The economic fates of

these firms would not also affect the income of the employer organization and, consequently, its capacity to make good on the promised pension benefits.

In short, while the local social investment is most easily conceived of in geographic terms, the externalities and lack of diversification that typify this kind of investment can be present in other situations.

An analysis of the proposal made to the state employees' pension plan makes a point, which, if perhaps obvious, nevertheless ought to be articulated: the mere existence of externalities cannot justify the local social investment. The externalities must be of sufficient magnitude to offset the lower direct return of that investment and must be captured by the fiduciary for the benefit of his beneficiaries. In the case of the proposal to the state pension plan, it appears that the proposed investments do not generate adequate externalities and that the externalities that do result do not benefit the plan's beneficiaries. Therefore, the proposed investment should not be made.

The externality to be realized from the low interest mortgages is increased tax revenue. That revenue will result from the sales tax collected on the purchase of materials for homes that otherwise would not be built and from the real estate conveyance tax on sales that would not take place in the absence of the low-rate mortgage plan. However, none of these tax revenues will be shared with the plan participants. The plan requires the state to contribute 5% of each participant's current salary annually. An increase in tax revenue as a result of the mortgage program would not generate increased contributions for the state's employees and thus does not counterbalance the depressed investment performance resulting from the low rate mortgages. Moreover, the state's financial position is reasonably good and, therefore, the strengthening of the state's revenues is, at best, of marginal importance to the plan participants.

In addition, if low interest mortgages are granted with the plan's assets, the plan's rate of return will be lower than it otherwise would be. Consequently, the funds available for distribution to employees at retirement will also be less.

For the plan participants, there is no need to examine this proposal from the viewpoint of diversification since the rate of return (10% with no externalities) is so unappealing.

VI. THE RECIPROCAL LOCAL SOCIAL INVESTMENT

It would, of course, be possible to alter the facts of the foregoing examples and thereby shift their tone and emphasis. We could, for

example, postulate that a smaller portion of the university's endowment has already been invested in downtown Westville and thereby reduce diversification problems with, and externalities from, the city's mortgage proposal. Or we could hypothesize greater problems quantifying secondary benefits than are evident in my examples.

Nevertheless, despite the possibility of tinkering with the details of my examples, they do establish the major points: local social investments are fundamentally different from global social investments. Despite a lower direct return, the local social investment can frequently be highly productive since some of its externalities will inure to the benefit of the fiduciary's beneficiaries and thus increase the investment's rate of return. On the other hand, the local social investment will typically be among the least diversifying choices available to the fiduciary.

The fiduciary confronted by proposals for local social investments could be paralyzed by this dilemma and respond by making no such investments at all. If he eschews all such local investments, the fiduciary runs no risk of managing an undiversified portfolio.

The problem with this essentially negative approach is that the local social investment will, because of its externalities, often be highly productive. The defensive decision to eschew all local social investments may depress the fiduciary's rate of return below levels otherwise obtainable by ignoring a category of investments which may be among the most productive available.

Nevertheless, the lack of diversification inherent in the local social investment cannot simply be dismissed out of hand. If the local social investment becomes unprofitable (a possibility that exists with any type of investment), the fiduciary may find himself in the uncomfortable position of defending an investment which he knew *ab initio* would decrease the diversification of his portfolio. Even if the fiduciary is confident that he could ultimately justify his decision in the appropriate forums, the prospect of extended proceedings in the state or federal courts is not an attractive one.

I suggest that there is a solution to the dilemma of the local social investment. That solution is for fiduciaries to reciprocate each other's local social investments.

Let us reconsider the position in which our hypothetical university finds itself. The mortgage proposal will undoubtedly enhance the university's real estate holdings. It will, however, further tie the university's economic fortunes to those of Westville. Suppose, however, that the university knows of another institutional investor in a similar situation, e.g., the church organization. The university and the

church organization could enter into a contractual commitment to invest in each other's project: the church organization's pension plan would grant the mortgage for the renewal of downtown Westville while the university would extend mortgages to the churches affiliated with the organization. From the perspective of rate of return, this reciprocation of local social investments produces the same result as if each institution had invested in its own project. The university's return on the church mortgages will be the same as it would have received on the investment in downtown Westville. The university will receive interest of 8%, plus the externalities derived from the church organization's extension of a mortgage in Westville that will benefit the university's real estate. By the same token, the church organization's cash return on the Westville mortgage will equal the return it would have received on the mortgages to its affiliates. In addition, the organization, by deploying its assets in Westville, secures the benefits of the university's investment in its affiliated churches.

Most importantly, the reciprocation by the university and church organization of their respective local social investments frees each from the diversification dilemma. The university will not be required to further concentrate its assets in Westville, but will invest in different areas in different parts of the country. Similarly, the church organization can diversify some of its economic fortunes out of the ambit of its affiliated churches.

In short, the reciprocation of local social investments mitigates, if not eliminates, the diversification problems inherent in such investments. By exchanging local social investments, fiduciaries can diversify their portfolios while still guaranteeing that capital is deployed in projects that generate significant externalities for the fiduciaries' beneficiaries.

As a practical matter, the establishment of a permanent, nationwide clearinghouse would be necessary to accomplish the reciprocation of local social investments on a regular basis. On the simplest level, such a clearinghouse would permit various fiduciaries to learn of each other's existence and of the investments each desires to reciprocate. On a more complex level, the clearinghouse could play a role in arranging multiparty exchanges of local social investments. In my examples, the proposals to the church organization and the university are of exactly equal size: each has been requested to loan \$10 million. On these facts, each can satisfy the other's needs by merely reciprocating between themselves.

Suppose, however, that the proposal to the university is for a \$12 million mortgage. The church organization, still only needing \$10

million for its purposes, might be reluctant to commit to Westville any more than the organization needs to have invested with its affiliated churches. Similarly, the university might prefer that an outside investor extend the entire \$12 million mortgage rather than only part of it.

One solution to this quandary is to coordinate a three-party exchange of local investments. The university could invest \$10 million in church mortgages to be reciprocated by the church organization with a \$10 million mortgage for downtown development in Westville. In addition, the university could invest another \$2 million in the Elmtown mortgage proposal in return for a \$2 million loan by the Elmtown home construction corporation to the Westville project.

As we move from simple two-party exchanges to multiparty arrangements, the role of the central clearinghouse becomes one of a broker, styling different packages in light of the various proposals registered with it.

In its ultimate shape, the clearinghouse could form the equivalent of mutual funds, pooling a variety of local social investments into a single, internally-diversified investment vehicle. Suppose, for example, that in any year there are forty fiduciaries with local social investment proposals totalling \$100 million. Suppose further that our hypothetical university's mortgage project is one of those proposals.

The clearinghouse could organize a pool to which the university would contribute \$10 million. In turn, the pool would extend the \$10 million mortgage to the developer for the rehabilitation of downtown Westville. Similarly, the remaining \$90 million in the pool would be used to make the local investments desired by the other participating fiduciaries.

For its \$10 million, the university would thus secure the benefit of its local investment and a diversified pro rata interest in each of the other investments in the pool.

In practice, assembling such a pool will not be without its difficulties. Different investments contributed to the pool will generate different direct rates of return and will entail differing degrees of risk. Accordingly, potential investors may be willing to partake in some of the pool's investments, but not in others. The university may be willing to extend a pro rata portion of the mortgage for Elmtown home buyers, but it may not be willing to invest in the mortgages for churches in low income areas. If we divide a single pool into smaller, separate pools, each with fewer investments, we increase the possibil-

ity that any given pool may be acceptable to a potential investor, but simultaneously decrease the diversity within each smaller pool.

In short, I do not minimize the practical problems involved in the establishment of mutual funds of local social investments. However, those problems do not seem insuperable or sufficient to preclude some initial experimentation with the establishment of such funds.

Among the issues that must be considered are who would organize such a clearinghouse and who would pay for its operation. Perhaps the most likely initial candidate is a foundation interested in social investing. If a foundation were to undertake to establish a clearinghouse and fund its initial period of operation, much useful information could be obtained, e.g., the number of institutions with projects to reciprocate; the total annual volume of local social investments contributed to the clearinghouse; the rate of return obtained by participants in the clearinghouse.

In short, this initial period of experimentation, during which the administrative costs of the clearinghouse would be subsidized by a foundation, would indicate whether there is, in fact, a demand for the services of the clearinghouse and whether, without the foundation's funding, the clearinghouse could be a self-sustaining enterprise.

If the results achieved by the clearinghouse are sufficiently favorable, the clearinghouse could be transformed into a self-financing organization. Institutions participating in the clearinghouse would pay fees designed to cover their respective shares of the clearinghouse's overhead. The clearinghouse would thus resemble a loaded mutual fund. Indeed, if the initial period of foundation-subsidized operation indicated the feasibility of the clearinghouse as a self-sustaining entity, the organizers of commercial mutual funds might find it profitable to organize and operate such clearinghouses.

Several financial organizations are examining the possibilities of establishing mutual funds for those concerned about socially sensitive investing. If the financial viability of a clearinghouse could be demonstrated during a period of foundation-subsidized operation, these financial organizations might consider forming clearinghouses for the reciprocation of local social investments.

VII. QUANTIFICATION, PRUDENCE, AND NONECONOMIC BENEFITS

The otherwise sympathetic reader may now feel compelled to interject three reservations. First, it may be suggested that my analysis requires fiduciaries to project and quantify the externalities to be obtained from proposed local social investments. Such prognostication

and quantification is somewhat problematic. Second, it may be argued that permitting fiduciaries to account for externalities could possibly lead them to advance their own social and political goals at the expense of their beneficiaries. Fiduciaries might simply predict externalities to justify and rationalize the fiduciaries' own policy preferences. Third, it may also be observed that my argument defines externalities in strictly financial terms and ignores the noneconomic benefits to be derived from potential investments.

My argument does assume that fiduciaries can, within reason, predict the financial consequences of proposed local social investments and quantify those consequences. I presume, for example, that my hypothetical university can anticipate, with reasonable certainty, the financial impact upon its real estate holdings of the proposed downtown development project. Similarly, I assume that pension and profit-sharing trustees can predict, and quantify, the impact of proposed investments upon the rates of return of the plans that the trustees supervise.

Predicting the future is problematic; quantifying the future, more so. Thus, it might be suggested that the impossibility of ever really knowing what externalities to expect makes it dangerous, if not impossible, for fiduciaries to consider those externalities in making investment decisions.

To this concern, I advance two replies. First, there are tools available for making financial predictions of this type. It is impossible to read any major financial publication without perceiving the wide array of appraisal and investment analysis services available to investors.⁹⁰

Second, and perhaps more compelling, my argument assumes no more (and no less) ability to predict and quantify the effects of potential investments than does current law. It is assumed by current law that the fiduciary can identify and invest in the most appropriate opportunities available to him. Fiduciaries are already required to prognosticate about rates of return and appreciation of capital when they make investments. My analysis thus assumes no more competence to divine future trends than does existing law.

In summary, the argument that fiduciaries will be required to predict and quantify the economic effects of local social investments proves too much. If such predictions and quantifications are beyond

⁹⁰ See, e.g., *Pensions & Investment Age*, Jan. 23, 1984, at 88 (advertisements for investment research); *id.* at 90 (monographs available from the Financial Analysts Research Foundation).

the competence of fiduciaries, then existing law, which presumes such competence as well, is similarly flawed.

As to the argument that the prediction of externalities will become an excuse for the fiduciaries' own policy preferences, I would observe that fiduciaries' predictions of expected externalities, like all of their other actions, are subject to the standard requirements of prudence and loyalty. Hence, fiduciaries are required to predict secondary economic benefits reasonably and in good faith, predicated on the financial well-being of the fiduciaries' beneficiaries. Thus, a breach of duty occurs either when a fiduciary predicts externalities from an investment without an adequate basis for such a prediction, or when he makes a prediction to advance his own political or personal agenda rather than the beneficiaries'.

My argument does define externalities in strictly financial terms. I do not consider, for example, the possibility that the downtown development project, by making Westville a more attractive place in which to live, will help the university recruit students or faculty.⁹¹ Similarly, I do not consider the possibility that a policy of noninvolvement with firms tied to South Africa will make the university more enticing to a type of pupil or professor the university seeks to attract.⁹²

It is not that I deny that noneconomic benefits may exist from any social investment. It is, however, my position that we lack any firm consensus for identifying and evaluating these benefits and that, accordingly, we are not ready (if we ever will be) to account for these benefits in fiduciary law.

The criteria for identifying and evaluating economic benefits are well established and essentially noncontroversial, largely because of their simplicity: a higher return is preferable to a lower return; capital appreciation is better than capital depreciation; more capital appreciation is better than less capital appreciation.

No such consensus exists as to noneconomic criteria. One man's environmentalism is, for another, a bias against economic growth.

⁹¹ I should note the theoretical possibility that a more attractive urban environment will allow the university to pay lower faculty salaries and charge higher tuition. If these economic benefits genuinely exist, they would increase the rate of return on the university's investment in downtown Westville. That, however, would still leave the question whether the noneconomic benefits vis-a-vis the university's student body and faculty ought be considered in the university's decision to invest in downtown Westville.

⁹² Similarly, if the adoption of anti-apartheid investment policies genuinely allows the university to charge higher tuition or pay lower faculty salaries, that would be an economic externality to be considered by the university's trustees. However, the question of the noneconomic aspects of an anti-apartheid policy still remain.

Disengagement from South Africa is a moral imperative for some, a disservice to South Africa's black majority for others. Even the noneconomic consequences of the revitalization of downtown Westville are far from clear—potential students for the university's school of social work might prefer a different kind of environment for their research and practice.

Hence, the omission of noneconomic benefits from my calculations is deliberate and, I suggest, defensible. Until there is a more widespread consensus as to the existence and extent of these benefits, we cannot tell fiduciaries to account for them.⁹³

CONCLUSION

As the decade progresses, we can expect that, for many fiduciaries, the dilemma of the local social investment will grow more acute. As America's industrial heartland seeks to revitalize itself, as America's cities cope with the imperatives of economic renewal, and as America's states and municipalities confront the need to house America's next generation, the growing assets of foundations, endowments, and pension and profit-sharing plans will represent an attractive source of capital with which to accomplish these tasks.

It will not do to ritualistically reiterate fiduciaries' duty of loyalty to their beneficiaries and, on that basis, to decline all opportunities for local social investments. As I have attempted to demonstrate, the local social investment will often be highly productive, sometimes more productive than the conventional deployment of assets by the fiduciary. Blanket opposition to local social investments may thus result in significantly lower rates of return than would otherwise be obtainable.

On the other hand, it will prove equally unsatisfactory to treat foundation, endowment, and pension and profit-sharing assets as freely available for any project that promotes the greater good of the commonwealth. Retirees have a legitimate expectation that the funds upon which they rely for postemployment income will be invested in a manner that secures their interests. Taxpayers who subsidize tax-exempt institutions for particular purposes are similarly entitled to have those institutions satisfy the specific purposes for which exemption is granted rather than more generalized social goals that may or may not be appropriately financed by the federal treasury.

The core of the problem is that the local social investment con-

⁹³ This is not the place for a comprehensive jurisprudential analysis of the nature of fiduciary relationships. For those interested in such an analysis, see Jacobson, *The Private Use of Public Authority: Sovereignty and Associations in the Common Law*, 29 *Buffalo L. Rev.* 599 (1980).

fronts the fiduciary with a dilemma. The local social investment may be among the most productive available to the fiduciary, since the investment's rate of return will include a portion of any externalities generated by the investment. However, it will be among the least diversifying available to the fiduciary since, in general, the fiduciary will already possess a significant investment in the locality.

My solution to this dilemma might, in practice, prove rather complex. The reciprocation of local social investments is advanced, not because it can be done easily, but because it constitutes the only practical resolution of this quandary. To those who prefer an intellectually purer or administratively simpler solution to the dilemma of the local social investment, I can do no better than declare that the solutions to important dilemmas are rarely pure and never simple.⁹⁴

⁹⁴ O. Wilde, "The Importance of Being Earnest," Act One (John W. Luce & Co. 1906).